IN THE

Supreme Court of the United States

OCTOBER TERM, 1920.

No. 609.

ELDORADO COAL AND MINING COMPANY,
Plaintiff-in-Error.

vs.

HARRY W. MAGER, COLLECTOR OF INTERNAL REVENUE FOR THE FIRST DISTRICT OF ILLINOIS,
Defendant-in-Error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION.

REPLY BRIEF FOR PLAINTIFF-IN-ERROR.

The argument in our original brief in this case was influenced necessarily by the theories of the Treasury Department. In the briefs of the Solicitor General now filed in this and the Merchants Loan and Trust Company Case, No. 608,[1] the Government's position is materially altered. The extreme views of the Commissioner of Internal Revenue are abandoned in several important respects, and a middle ground is sought upon which to sustain an income tax upon gains real-

[1] References herein to the Government's brief are to the brief in the Merchants Loan and Trust Company case No. 608, which is adopted as the Government's brief in the case at bar also.

ized in *cash* by a sale of a capital investment *under the Act of 1916*, although it is conceded that *such gains were not taxed as income by the Act of 1913.*

We shall show that this middle ground cannot be sustained for the same reason that the extreme views of the Commissioner must fail—because both rest upon the same fundamental fallacy which was pointed out in our original brief.

I.

THE GOVERNMENT CONCEDES THAT, UNDER THE INCOME TAX ACT OF 1913, A GAIN REALIZED IN CASH BY THE SALE OF A CAPITAL INVESTMENT WAS NOT TAXED AS INCOME, AND FAILS TO JUSTIFY SUCH A TAX UNDER THE ACT OF 1916.

In its effort to distinguish the cases of *Gray* vs. *Darlington*, 15 Wall. 63, and *Lynch* vs. *Turrish*, 247 U. S., 221, from the case at bar, it is conceded by the Government's brief that a gain realized by the sale of a capital investment was not taxed by the Act of 1913 and would not be by an Act like that of 1867. (Brief for Defendants-in-Error, pp. 27-28.) This conclusion is based upon the statement that those statutes taxed income *arising and accruing* during the preceding year, and that this court held in those cases that income did not arise or accrue in the year in which a capital investment was sold, nor in any prior year in which an advance in the value of the capital investment took place. In other words, the Government admits that those cases decide the precise points which, in our original brief, we contended that they did.

But the Government now contends that the language

of the Act of 1913 was abandoned by Congress when it passed the Act of 1916, that the Act of 1916 taxes income *received* during the preceding year, and that a gain realized in cash by a sale of a capital investment is income *received* in the year of the sale, even though it never at any time arose or accrued as income. We pointed out repeatedly in our original brief that income which never happens, never arises or accrues, cannot be received. No attempt whatever is made in the Government's brief to meet this difficulty.

In fact, the Government's argument on this point is not consistent with itself. It is insisted both that income accrues and that it does not accrue prior to the sale of the investment at an advance in value. The alleged analogous case of a man who loaned money on a note payable in ten years after date with interest payable at maturity illustrates this. The contention is stated in these words (p. 33):

> "In such a case the interest which, when received, would be income, *would be accruing over a period of 10 years*, but it would *all become income* in 1 year—that is, the year when received."

Not only is this statement contradictory in itself, but it shows that the case put is not an analogous one. It is obvious that interest accruing during ten years on an investment is not similar to increase in the value of the investment itself during that time, which admittedly does not accrue as income during the ten years or in the year of the sale of the investment, and so, as we contend, cannot be received as income. That such increase in capital does not accrue as income prior to the sale of the investment for cash is expressly stated in the Governments' brief in the following language (p. 18):

> "In other words, *a mere increase in value, while it remains such, is not income.*"

Referring to gains in capital it is said (pp. 32-33):

> "*During the time that they have been thus accruing they were not income.*"

We shall quote, *infra*, other statements from the Government's brief to the same effect.

We submit that there is no explanation in the Government's brief of how a gain which never arises or accrues as income can be received as income. The Act of 1916 is, in fact, no more effectual to tax such a gain than is the Act of 1913.

II.

THE GOVERNMENT, IN ITS BRIEF, CLAIMS THAT INCOME IS RECEIVED BY THE CONVERSION OF A CAPITAL INVESTMENT WHICH HAS INCREASED IN VALUE ONLY IN CASE THE INVESTMENT IS SOLD FOR MONEY.

We pointed out in our original brief that the Commissioner insisted upon the payment of an income tax in the case of the exchange of capital investments which had increased in value. The brief for the Government abandons this contention. The argument is based entirely upon the proposition that no income arises until the capital investment which has increased in value is sold for money. A gain in capital, the contention is, can be realized as income only by a sale for money. The Government's contention is stated as follows (Brief, pp. 16-17):

> "When property is sold at an advance over what it has cost, the proceeds of sale include both

> the capital and the income which has resulted. The amount of income is to be ascertained by withdrawing from the proceeds of sale the amount of capital which has been invested. What remains is the income which has been produced by or derived from the capital. *When both are reduced to cash* the income is something separate and distinct. It can be used or expended without, in any way, using or expending the cash which, after the sale, represents the capital. * * * *Hence nothing which falls short of separating the income from the capital can be said to result in the receipt by the owner of the income, and the present law taxes income only when it is received.*"

Again, the Government's brief quotes the language of this court in the case of *Eisner* vs. *Macomber*, 252 U. S. 189, to the effect that to tax a stock dividend is to tax capital increase, because "it requires conversion of capital in order to pay the tax," and then says (p. 34):

> "But when capital assets are sold there is no such result. *The seller has a lump sum in cash.* Out of this, he takes the amount of his capital. *What is left is the income out of which he pays the tax,* leaving his capital, in its converted form, untouched."

It follows, from this contention, that if a trustee, an individual or a corporation desires to convert an investment which has increased in value, an income tax can be avoided by exchanging one investment for another without using money as a medium for accomplishing the exchange. This is a complete abandonment of the position of the Commissioner of Internal Revenue, as appears from our former brief (pp. 53-54).

III.

THE GOVERNMENT'S BRIEF DOES NOT CORRECTLY STATE THE RULINGS OF THE TREASURY DEPARTMENT UNDER THE ACT OF 1909.

The statement in the Government's brief is as follows (p. 20):

> "In collecting taxes both under the act of 1909 and the subsequent income tax laws, the administrative department of the Government has recognized that mere increase in the value of property, so long as not segregated from the property, is not income, but that when realized and segregated by a conversion into cash it is income.

As we pointed out in our former brief (p. 80) the claim of the Department under the Corporation Excise Tax Act of 1909 was based upon book entries, which resulted in a tax on mere increase in value, and not upon a *sale* which it was claimed realized income for the first time from such an increase in capital value.

The regulations under the Act of 1909 expressly stated:

> "It is immaterial whether any item of gross income is evidenced by cash receipts during the year or in such other manner as entitle it to proper entry on the books of the corporation from January 1 to December 31 for the year in which return is made." (Paragraph 5, Article 2, Treasury Department Regulations 31.)

When capital assets were sold, the tax was adjusted with reference to any tax on increase in value which might previously have been paid upon the basis of book entries. (Treas. Dept. Regulations 31, Art. 2; Treas. Decision 2130.)

The Department was defeated on this contention in the courts in 1915. See *Baldwin Locomotive Works* vs. *McCoach*, 221 F. 59.

These book entry regulations were adopted as the regulations of the Department under the Act of 1913, and of course applied only to corporations. Art. 107 of Treasury Department Regulations 33 stated,

> "It will be noted from these definitions that the gross income embraces * * * appreciation in values of assets, if taken up on the books of account as gain."

As pointed out in our former brief, the theory of a realized gain by virtue of a sale was not developed by the Department until after the Act of 1916 was adopted.

As shown above, it is now conceded by the Government's brief, that in view of the decision by this court in *Lynch vs. Turrish*, a gain realized by a sale of capital assets was not taxed as income by the Act of 1913.

IV.

THE CONTENTION IN THE GOVERNMENT'S BRIEF THAT A TRUSTEE WHO SELLS STANDS IN THE PLACE OF THE TESTATOR AND MUST PAY THE TAX WHICH THE TESTATOR WOULD HAVE PAID IF LIVING IS ALSO OPPOSED TO THE POSITION OF THE TREASURY DEPARTMENT.

In the Government's brief, referring to a testamentary trustee, it is said, (p. 35):

> "When he receives property which has belonged to his testator he merely succeeds to the status of the latter with respect to that property and, on a sale made by him, must account for the same

profits which would have been income when received by the testator if living and making a sale."

This statement is inconsistent with the ruling of the Department, which made the appraised value at the time of the death of a testator the basis for determining gain or profit on a subsequent sale. (Treas. Dept. Regs. 33 Rev., par. 44; Reg. 45, Art. 343.)

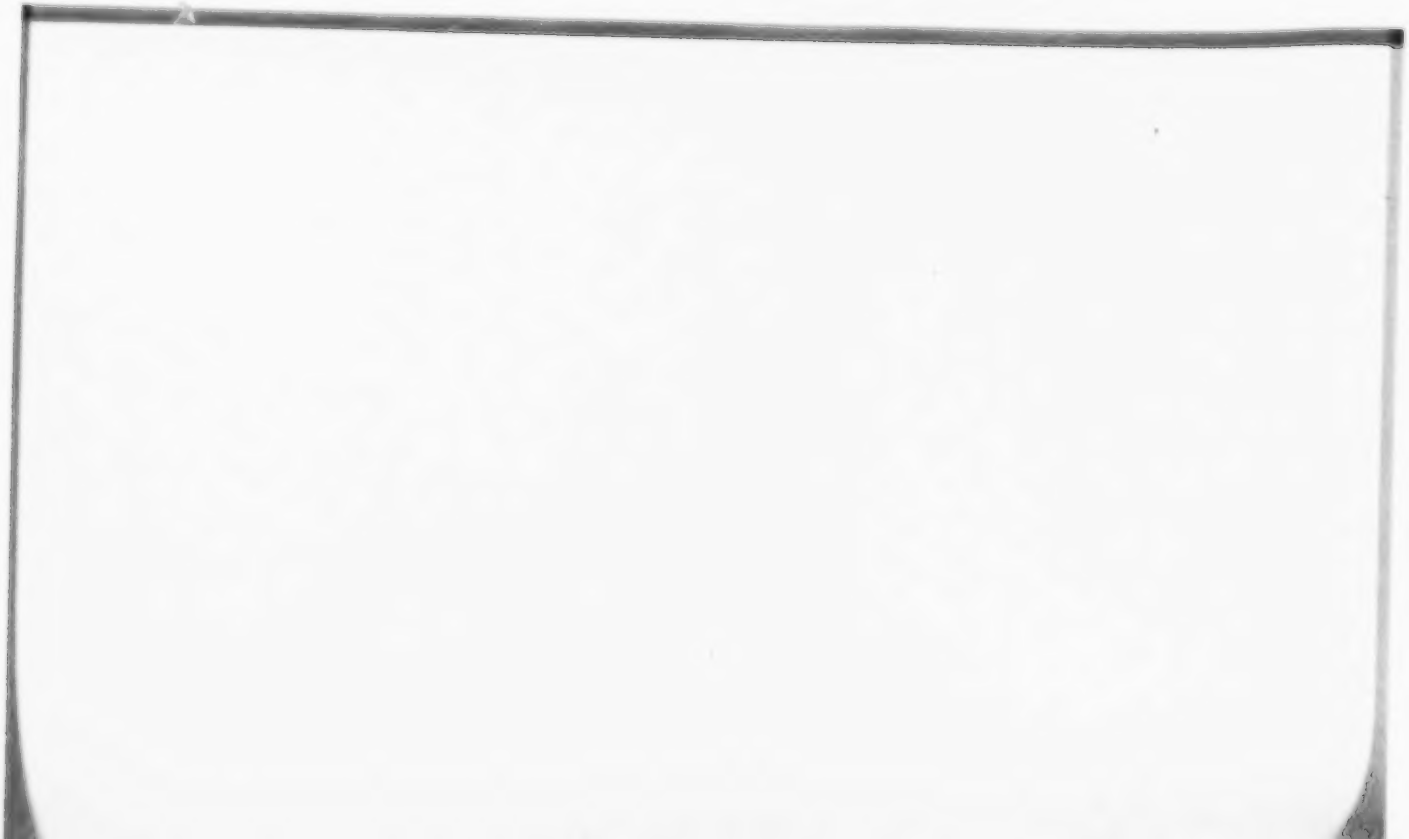
Furthermore, the fact that property was acquired by a trustee prior to March 1, 1913, does not obviate the necessity of ascertaining cost in order to see if any profit was realized from a sale after that date. The March 1, 1913, value is material only where a profit has in fact been realized, and if there was no cost to the trustee there is no basis for ascertaining profit. The Government's effort to use cost to the testator as the basis for determining the profit of the trustee is an admission that in fact the property cost the trustee nothing. The life tenant and the remaindermen cannot be taxed on the basis of cost to the testator without making them taxable on account of the income of another person, if it be assumed that there is income at all in such a case.

The Government makes no comment in its brief on the rulings of the Department with reference to property turned over to a corporation for its stock and subsequently sold by the corporation. (See our former brief, p. 69.) Is there any cost to the corporation in such a case? Neither does the Government's brief explain how a corporation as well as its stockholders can receive income on a winding-up sale.

We respectfully submit that the judgment in this case should be reversed.

Respectfully submitted,

HERBERT POPE,
Counsel for Plaintiff in Error.



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PETITION FOR REHEARING.

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